

JAPAN ECONOMIC CURRENTS

A COMMENTARY ON ECONOMIC AND BUSINESS TRENDS

How Private Finance Initiatives Expand the Private Sector and Promote Foreign Investment in Japan

by Kiyotaka Morita, Nippon Keidanren

Nippon Keidanren, the Japan Business Federation, has long endorsed the need for Private Finance Initiatives (PFI). PFI is a method of providing public services using private funds – instead of government involvement, the private sector is solely responsible for the funding, facility construction, and supply of public services. Invested capital is extracted by the private sector through the service charges that are imposed.

PFI would be a catalyst for two powerful multiplier effects to the Japanese economy:

Compared to the services provided by the public sector, improvements in quality, creativity and ingenuity of the private sector would logically flow;

And, as the private sector enters sectors once the exclusive domain of government monopolies, private business opportunities would naturally expand.

Nippon Keidanren referred to these welcome spillover benefits in its September 1998 position paper, "Promotion of PFI." As a result, in September 1999, the Diet enacted a PFI bill that included the following basic principles:

The responsibilities on the part of the national and local government and the private sector shall be clearly spelled out;

Profitability shall be ensured;

And, by minimizing the interference of the public sector into private business, technical and managerial resources of the private sector, along with its creativity and ingenuity, will be enhanced so that high-quality service will be provided to the public.

Since the enactment of the law, projects based on Private Finance Initiatives have steadily increased in

number. Not surprisingly, however, three problems quickly emerged:

- 1) A range of rules and regulations hamper the realization of PFI projects by inhibiting ingenuity and creativity;
- 2) Inherent rigidities in the bidding system and often non-transparent procedures;
- 3) Provisions that must be clearly set forth in the contract (such as the role of public and private sector in risk mitigation) do not receive proper emphasis or are sometimes even neglected altogether.

To respond to these problems, Nippon Keidanren issued "The Second Position Paper on Promotion of PFI," in June 2002 and more recently, a third position paper with a view to encouraging the government to better deal with these problem areas.

Coincidentally, the national government is looking forward to stocktaking and, possibly, revising the PFI law later this year. Nippon Keidanren expects its position to be reflected in the policy modification.

Nippon Keidanren Weighs in

In its three PFI policy papers, Keidanren makes four points:

Currently No.41 February 2004

Japanese and American Companies Urge 4
Ratification of New Income Tax Treaty
by Judy Scarabello,
National Foreign Trade Council

Promoting Corporate 6
Social Responsibility
Nippon Keidanren
Position Piece,
February 17, 2004

The 2005 World Expo, Aichi, Japan 7

How Private Finance Initiatives Expand the Private Sector and Promote Foreign Investment in Japan

First, the majority of PFI projects to date have concentrated on the construction of facilities. But from the standpoint of the expansion of the private sector's domain, PFI does not need to be restricted only to facility construction – the provision of high-quality services and efficient management are precisely the areas in which the strengths of the private sector are often best utilized. Needless to say, many foreign corporations that are considering an expansion of their businesses into Japan possess unique service and management know-how. Thus, it is important to actively promote PFI projects that focus on the provision of services and business management. Recent cases include the construction of public hospitals by local and municipal governments, with the private sector providing medical and related services and engaging in hospital management. In the future, the number of such projects can be expected to increase.

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Second, in the provision of public services through PFI projects, emphasis must be placed on quality so that the creativity and ingenuity of the private sector is fully utilized. Thus, in the

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evaluation and selection of private business entities, cost factors should not be given undue importance at the expense of quality, creativity and ingenuity.

Furthermore, in selecting private business entities, it is important that transparency be ensured in the evaluation process. Reasons why a particular applicant was not chosen should be clearly explained, and third party arbitration should be systematically employed if there is any suspicion of irregularity.

Third, since PFI projects are promoted by private firms, regulations that hamper profitability must be done away with to the fullest extent possible. Under the existing PFI Law, if private facilities are added onto public facilities, there is a regulation which de facto prohibits the transfer of ownership of those private facilities to a third party. For

example, if stores are established in one part of a government office facility constructed and maintained under PFI scheme, the private company operating the PFI project must maintain ownership of those

stores, even if there is no limitation upon replacement by tenants. Such regulations obstruct the extraction by private enterprises of invested capital and inhibit business diversification. This kind of regulation must be eased as rapidly as possible.

And fourth, from the standpoint of providing public services over a long period of time, if PFI are involved, the method for resolution of whatever problems might arise in the future must be clearly set forth in the contract.

Some regional public entities seem to believe that because “future legislatures cannot be controlled by contracts,” even in the event that the public sector should pay indemnities to private businesses following the dissolution of a PFI contract, the legislature would have to vote once again on the measure. If obligations required in accordance with a contract (such as indemnity payments) cannot be fulfilled until a legislature again votes on the matter, that contract would lack stability. Thus there is a need to develop guidelines that lead to clarity in contracts.

Moreover, from the standpoint of stable continuation of PFI projects, even if a private enterprise defaults, it should not be a reason to break

off the contract. Rather, in order to complete the project, the lending institution should, under the contract, be authorized to temporarily purchase all of the contractual rights/assets, in consultation with the public sector, and to transfer those rights/assets to a third party chosen by the financial institution.

environment to promote foreign direct investment in Japan. In many cases, investment in Japan entails the cross-border shift of not only capital, but also valuable corporate management resources such as new business models, new technology and materials, and new management know-how. Such investment creates

- Simplify and speed up administrative procedures while eliminating arbitrary decisions; and
- Promote the outsourcing of state-run programs to the private sector;

PFI could be a key in achieving these aims. The cost of social capital formation could be reduced by PFI by harnessing the creativity and ingenuity of the private sector. Ensuring transparency in PFI procedures and in the bidding system could lead to ensuring transparency in administrative procedures as a whole. And promoting PFI would encourage the outsourcing of state-run programs to the private sector.

More broadly, improvements in the business climate aimed at the promotion of PFI will enhance investment in Japan by foreign countries. Hopefully, the voices of foreign corporations pushing for improvements in Japan's investment environment will help to liberalize domestic regulations, including the various rules surrounding PFI, and will lead to overall transparency, with mutual benefits for all. ■

“In its July 2002 position paper, “Toward for the Creation of International Investment Rules and Improvement of the Japanese Investment Environment,” Nippon Keidanren urges the government to improve the domestic investment environment to promote foreign direct investment in Japan”.

Finally, the disposition of stocks by private entities often requires approval from the public authority but the requirements for doing so are not clear. For the purpose of attracting private capital from diverse sources, so long as certain criteria are met, the public authority should recognize stock sales as valid and include provisions for them in the contract.

Improving the Foreign Investment Environment

In its July 2002 position paper, “Toward for the Creation of International Investment Rules and Improvement of the Japanese Investment Environment,” Nippon Keidanren urges the government to improve the domestic investment

environment to promote foreign direct investment in Japan. In many cases, investment in Japan entails the cross-border shift of not only capital, but also valuable corporate management resources such as new business models, new technology and materials, and new management know-how. Such investment creates jobs in Japan and stimulates intra-company cross-border transactions which expand economic ties between Japan and the home country. Investment in Japan will also help to prevent the feared hollowing-out of industry, as well as stimulate domestic competition, increase economic efficiency and advance industry. The resulting virtuous cycle created in Japan as an investment host will boost the domestic economy.

In order to promote investment in Japan, the Nippon Keidanren urges the following steps be taken:

- Improve the efficiency and reducing the cost of social capital formation;

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Japanese and American Companies Urge Ratification of New Income Tax Treaty

by Judy Scarabello, National Foreign Trade Council

In November 2003, the Japanese Ministry of Finance and United States Treasury Department agreed to a new bilateral income tax treaty to replace the original of 1971.

If enacted, the treaty would eliminate double taxation of businesses involved in two-way trade, reduce withholding rates and bring welcome relief from investment distortion to Japanese and American companies.

The US Congress and Japanese Diet are setting legislative schedules aimed at producing an early ratification of the treaty. The chairman of Senate Foreign Relations Committee, Richard Lugar (R-Indiana), has scheduled a hearing for late February. Typically the Senate Foreign Relations Committee approves tax treaties without reservation or amendment, which then move to the full Senate for debate. Upon a two-thirds vote, the instruments of ratification are prepared and the measure is signed into law by the President.

The National Foreign Trade Council (NFTC), a Washington, DC-based association of industrial, financial, and service companies – many of them significant investors in Japan – has worked hard with business interests and the Treasury Department to push progress on the tax treaty.

Target Date

The NFTC is hopeful that the Senate will complete its ratification procedures so that instruments of ratification can be exchanged before April 1, 2004. If Congress acts by this target date, there will be no delay in companies receiving speedy tax relief – the treaty's withholding provisions go into effect July 1, 2004, if both parties have completed their ratification process by March 31, 2004. If not, treaty benefits will be delayed until January 1, 2005.

In the first few months of every calendar year, the Japanese Diet devotes its attention to budgetary matters. Japanese treaty ratification procedures are substantially similar to US procedures, leaving some doubt about the lawmakers' ability to attend to the budget and also meet the April 1 tax treaty deadline for early ratification.

Because of the significance of the treaty to business interests in Japan and the US, at the NFTC's request, Senator Lugar issued a January 30, 2004, letter informing the Japanese of the Senate Foreign Relations Committee's efforts to meet the early ratification deadline and urging them to do likewise. The letter can be found on the NFTC's website (www.nftc.org).

Tax treaties are designed to eliminate double taxation of companies engaged in cross-border trade by allocating taxation jurisdiction between the two countries. By lowering the net return of foreign investments when foreign tax credits begin to exceed a company's capacity to use them, double taxation is an impediment that leads to distortion of investment decisions. Modern tax treaties also provide for administrative cooperation between the relevant tax authorities.

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The Japan-US treaty fulfills those purposes. It reduces withholding rates on cross-border payments, it provides for cooperation between tax authorities, it fixes some unresolved issues arising under the previous system, and it cracks down on tax abusers.

Taxation of dividends under the treaty is one major change. Dividends paid from firms in one country to residents of the other are now less encumbered by withholding taxes. For certain holders of more than 50 percent of the stock of a company, a zero percent withholding rate applies. This is a notable improvement on the 80 percent control test for the exemption in last year's UK-US treaty.

Competent Authority

A framework for the resolution of disputes with respect to overlapping claims by the respective governments – known as the Competent Authority process – is also provided for in the treaty. The Competent Authorities of the US and Japan may also cooperate with taxpayers and enter into Advance Pricing Agreements (APAs) in regards to transfer pricing between related entities. And the treaty provides a mechanism for appeal to home tax authorities if a company believes itself to have been unfairly treated.

Finally, the bilateral tax treaty includes limitation of benefits provisions intended to prevent usage of an entity in one of the

Ratification of the new Japan-US tax treaty is of paramount importance to businesses involved in two-way trade. The NFTC has for years urged negotiation of a new treaty, and the Koizumi and Bush Administrations have responded with a groundbreaking, progressive document. ■

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“Ratification of the new Japan-US tax treaty is of paramount importance to businesses involved in two-way trade...”

An exemption from withholding tax on interest payments was added in the new Japan-US treaty for certain financial institutions and pension funds. Royalties are generally exempt from tax as well. Due to the profusion of hybrid entities in the time since the negotiation of the original treaty, the tax status of these entities has been addressed.

nations to act as a conduit. These sections generally disallow beneficial ownership of items of income to nonresidents who would not otherwise be eligible except for their stake in the resident. A separate article on limitation of benefits clarifies the rules for determination of an entity's residence.

Promoting Corporate Social Responsibility

Nippon Keidanren Position Piece, February 17, 2004

Promoting CSR: A Top Keidanren Priority

As the world economy and circulation of information globalizes and consumer awareness evolves, public understanding of corporate social responsibility (CSR) is growing, as is interest in expanding its scope.

Corporate social responsibility is a sprawling term that encompasses economic, environmental, and social aspects of corporate activities that are aimed at ensuring that companies behave within the spirit and the letter of the law, both at home and in their overseas markets. Exercising CSR is a win-win practice – while enhancing corporate values, it also boosts competitiveness.

Nippon Keidanren has long promoted CSR as an important component of corporate activities to its member industrial associations and companies and intends to keep pace with the newly-expanded scope of CSR.

CSR should be left to individual companies – not bound by law or international standards

Keidanren's Council for Better Corporate Citizenship (CBCC) has studied CSR since 1989. During a

December 2003 survey mission to the US and Europe (called the "Dialogue Mission on Corporate Social Responsibility,") a CBCC delegation learned that American and European companies not only seek to minimize any negative impact their corporate activities may have, but also to make sustainable social contributions.

Nippon Keidanren believes that socially responsible management and communication work best when companies pursue their own corporate strategies and priorities. CSR guidelines should be voluntary – legal requirements or across-the-board standardization is not a solution.

Nippon Keidanren's revised Charter of Corporate Behavior

Keidanren's thrice-updated 1991 Charter for Corporate Behavior can be found at: <http://www.keidanren.or.jp/english/policy/cgcb.html>) In 2002, Keidanren took one step further by asking its member associations and companies to promote ethical corporate conduct within their own corporations by writing or strengthening their own charter or codes of conduct. In a follow-on survey, it was found that, many responding to Keidanren's request by establishing their own promotional system and

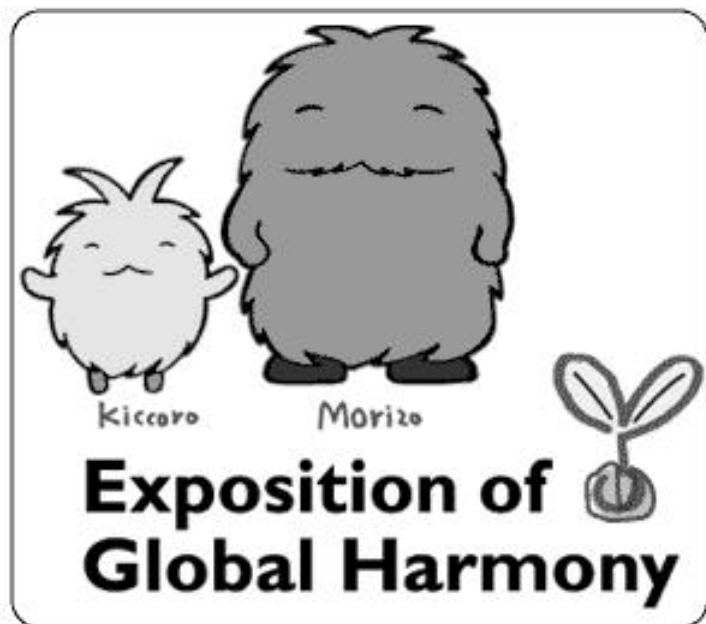
implementing educational programs.

To follow up the Charter revision and to ask its member companies to further the outreach, Nippon Keidanren designated October as "Corporate Ethics Promotion Month" during which its member companies are asked to thoroughly review their undertakings and to further promote education and training programs

The ten articles of the Keidanren Charter address the key issues and relationships that affect most CSR stakeholders – users and consumers, employees, environment, the market, overseas undertakings, stockowners, and social philanthropy. Nippon Keidanren will revise the Charter and Guidelines from global CSR perspectives. Upon approval, the revised Charter will be presented to companies as a comprehensive guideline for CSR.

Social responsibility is a matter of concern for all components of society and not necessarily limited to corporate behavior. Indeed, to be a powerful catalyst for change, all sectors of society, including administrations and NGOs, should consider social responsibility as part of their mission. ■

The 2005 World Expo, Aichi, Japan



Question: What do the Eiffel Tower, ice cream cones, hot dogs and the Space Needle have in common?

Answer: All made a debut at the World Exposition – the Eiffel Tower was built for the 1889 World Exposition held in Paris, ice cream cones and hot dogs made a debut at the 1904 Expo held in St. Louis, Missouri, and the famed Space Needle was built for 1962 Seattle Exposition.

The first World Exposition in the 21st Century will be held in Aichi, Japan from March 25 through September 25, 2005. Some 125 countries, including the United States, and eight international organizations have already pledged to participate.

Nagakute Area

The main theme of the Aichi Expo is “Nature’s Wisdom” which will be reflected in two distinct areas: the larger Nagakute area will boast the Global Commons where the participating countries will host their exhibitions; the Global Loop – a 2.6 kilometer barrier-free, elevated walkway that connects the six Global Commons; the Central Zone, a huge, high-tech pavilion where visitors can experience communications and exchange events that symbolize a Grand Intercultural Symphony and host a nightly ‘Koi Pond Event’; the networked, open air Expo Plaza, and the Japan Plaza, home to the Government Pavilion, Aichi Pavilion, the Central Japan Region Pavilion, and the Nagoya City Pavilion.

Also housed in the Nagakute area will be the nine sector-specific Corporate Pavilions (electric power, transportation, automotives, high-tech, e-commerce, energy, broadcasting, and the like), where companies will set up exhibitions and display their visions for the future.

The massive Convention Hall will feature specific programs related to Technology and the Creation of Goods, Inventions, Cities, Streets and Water, Children and Global Exchange, and Science for Youth.

Seto Area

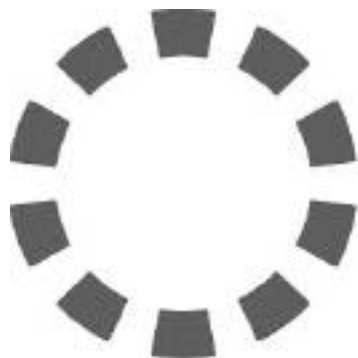
Based on the philosophy of “satoyama culture,” a way in which people live in harmony with nature in a traditional Japanese way, the Seto areas feature special attractions:

The Citizen Participation Zone where citizens and civic groups from around the world come together to work on the challenges faced by global society.

In the interactive Fun Zone, Non-Profit Organizations and Non-Governmental Organizations will come together in the NGO Global Village to teach visitors about



Continued on page 8



EXPO 2005 AICHI JAPAN

Further information about the 2005 Aichi Expo and details on how to participate can be found at <http://www.expo2005.or.jp>



Japan 2005 Expo from page 7

future generations, sustainable growth, and stewardship of the Earth.

And in the Forest Experience Zone, visitors can interact closely with nature.

In the planning stages is still the Kids Expo, which will be promoted by the Expo's official mascots – the cuddly Morizo, Forest Grandfather, and Kiccoro, the Forest Child. ■

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Keizai Koho Center (KKC) is an independent, non-profit organization designed to promote the understanding of Japan's economy and society at home and abroad. Its financial resources are derived entirely from the private sector.

KKC fosters a deeper understanding of Japan's basic social structure. Furthermore, it conducts public affairs activities to improve the Japanese people's recognition of Japan's global role.

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